PUBLIC DISCUSSION DRAFT ON INTEREST DEDUCTIONS PROPOSES WORLDWIDE INTEREST ALLOCATION RULES

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PUBLIC DISCUSSION DRAFT ON INTEREST DEDUCTIONS PROPOSES WORLDWIDE INTEREST ALLOCATION RULES
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1. Introduction

On 18 December 2014 the OECD released the public discussion draft on interest deductions and other financial payments ("the discussion draft"). The discussion draft deals with the first topic covered by Action 4 of the Action Plan on Base Erosion and Profit Shifting.[2] Action 4 calls for the development of recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense and other financial payments that are economically equivalent to interest payments. Action 4 also refers to the development of transfer pricing guidance for related party financial transactions. This issue is not addressed in the discussion draft. The discussion draft only looks at a number of different options for approaches to tackle base erosion and profit shifting ("beps") through the use of interest cost. It is observed that "there is a sense that unilateral action by countries is failing to tackle some of the issues at the heart of this problem. Partly, this is because the fungibility of money and the flexibility of financial instruments have made it possible for groups to bypass the effect of [unilateral interest limitation rules]".[3] A consistent approach utilising international best practices is needed. This aim may be best achieved "through rules which encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group. Overall, however, in general groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost."[4]

The present author welcomes the worldwide approach that is suggested in the discussion draft. This article discusses the discussion draft's approach to tackle beps through the use of interest cost. Paragraph 2 outlines the main policy concerns. Paragraph 3 provides an overview of the discussion draft's worldwide approach. Paragraph 4 will examine whether the worldwide interest allocation rule meets the policy concerns.

2. Main policy concerns

2.1. Introductory remarks

The critical objective of the discussion draft is to identify solutions to address beps using interest on third-party and related party loans. In addition the discussion draft recognises the following policy issues[5]: (i) avoiding double taxation, (ii) providing certainty of outcome and

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[2] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing.
[3] Para 5.
[4] Para 10.
[5] Para 11 and 13.

minimising distortions to competition and investment and (iii) EU law issues. In addition the author shall address whether an interest limitation rule that is based on a world-wide approach provides a balanced allocation of interest cost between the entities of a multinational group. These issues will be discussed hereafter.

2.2. Addressing beps

In most countries, interest on debt is subject to certain conditions treated as deductible for the payer and taxed in the hands of the payee. In a cross-border context debt financing can be used as a tool to erode the tax base. This creates competitive distortions between groups operating internationally and those operating in the domestic market.[6] Techniques to achieve beps through the use of interest cost include (i) the use of intragroup loans to generate deductible interest cost in high tax jurisdictions and taxable interest income in low tax jurisdictions, (ii) the use of interest deductions on loans that fund the acquisition of equity participations that produce dividends which are exempt or deferred for tax purposes, (iii) the allocation of a disproportionate share of the group's total third party interest cost to high-taxed operating companies, and (iv) the development of hybrid mismatches (e.g. hybrid instruments which give rise to deductible interest expense but no corresponding taxable income).[7] To be effective, a general interest limitation rule needs to tackle these beps techniques.

2.3. Avoiding double taxation

The discussion draft observes that "[r]ules to limit relief for interest deductions may result in double taxation where (i) the entity remains taxable on income funded by the interest, or (ii) the recipient of the interest remains taxable on the corresponding receipt."[8] In the author's view, the first observation is incorrect. Whether the entity remains taxable on income funded by the interest or not is irrelevant for the purpose of determining whether double taxation arises as a result of an interest limitation rule. Double taxation *may* arise if interest that is not deductible for the debtor is taxable for the creditor (the second part of the discussion draft observation). However, even in that case double taxation will only arise if an amount of interest that is not deductible for the debtor is not matched by a corresponding deduction for another entity within the group. That is why the author suggests that a disallowance of a deduction of interest at the level of a thinly capitalised group company should be offset by a corresponding extra deduction of interest at the level of an overcapitalised group company.[9] Instead the discussion draft favours provisions for the carry forward of disallowed interest expense into future periods. Whatever choice is made, a general interest limitation rule should avoid that interest is subject to economic double taxation.

2.4. Providing certainty of outcome and minimising distortions to competition and investment

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[6] Para 3.
[7] Para 3 and 4.
[8] Para 11.
[9] Vleggeert, Interest Deduction Based on the Allocation of Worldwide Debt, Bulletin for international Taxation 68(2), p. 104. See also the author's PhD thesis on interest deduction restrictions in international tax law, J. Vleggeert, Aftrekbeperkingen van de rente in het internationale belastingrecht, Fiscale Monografie nr. 132, Deventer Kluwer 2009.

According to the discussion draft, an interest limitation rule should be relatively straightforward to apply and the implications of the rule should be predictable. Moreover groups in the same economic position with respect to their funding should be treated consistently.[10] Furthermore, in order to avoid groups shifting investment to countries with less restrictive rules, an interest limitation rule should be applied consistently by as many countries as possible.

2.5. EU law issues

The discussion draft recognizes the need to comply with the EU treaty freedoms, directives and State aid restrictions in order to enable the 28 EU Member States to implement the worldwide interest allocation rules. As the work on Action 4 progresses, further consideration will be given to these EU law issues and how they impact on the design of interest limitation rules.[11] The discussion draft notes that there are a number of approaches that the countries involved have discussed in order to avoid a restriction of the EU treaty freedoms. Apparently, one of the approaches concerns an interest limitation rule that makes a distinction between domestic and cross-border situations, because the discussion draft recognises that consideration should be given the circumstances in which EU member states could justify a restriction of the EU treaty freedoms.[12] In this context grounds of justification that need further examination are in particular (i) the need to preserve the balanced allocation between EU member states of the power to impose taxes, and (ii) the need to prevent tax avoidance and to combat artificial arrangements. The author will not make this analysis in this article. However, the author wants to address the situation where the analysis would show that a prima facie restriction *cannot* be justified. In that case, an interest limitation rule should in principle also apply to a group that operates domestically only. It follows that an entity that is part of a domestic group could be confronted with an amount of interest that is not deductible under an interest limitation rule. This result would conflict with the policy objectives underlying an interest limitation rule as a group that operates domestically only cannot be involved in beps.

It could be argued, however, that domestic groups could avoid the application of an interest limitation rule by filing a consolidated tax return (fiscal unity). On the other hand, the threshold for filing a consolidated return may differ substantially from the criteria on the basis of which it is determined whether the company is part of a group for purposes of interest limitation rule. This can be illustrated by the Dutch thin capitalization-rules that applied from 2004 to 2013. These rules aimed to counter the excessive allocation of interest expenses to Dutch entities that were part of an international group. However, in order to comply with the EU treaty freedoms, the thincap-rules also applied to domestic groups. In order to determine whether an entity was part of a group for purposes of the thincap-rules, general accepted accounting principles were decisive. Although domestic groups could avoid the application of thincap-rules by entering into a fiscal unity, many small and medium sized enterprises that operate only within the domestic context were still confronted with the thincap-rules. This was because in these situations, the threshold for forming a fiscal unity (95% shareholding) often provided harder to meet than the requirement of a group under the thincap-rules.
The fact that domestic groups faced non-deductible interest as a result of the thincap-rules, was highly controversial and played a major role in the decision to repeal the rule as of 2013.

[10] Para 11.
[11] Para 236.
[12] Para 231. A justification is only needed when there is a prima facie restriction.

In the author's view this illustrates that an interest limitation rule can only be sustainable if it avoids that domestic groups will be subject to economic double taxation on interest.

2.6. A general interest limitation rule should be fair.

The discussion draft's chapter on policy considerations does not explicitly mention that a general interest limitation rule should be "fair". The discussion draft does not define this concept, but it is clear that the principal concerns in this respect are to (i) enable groups to obtain tax relief for an amount equivalent to their actual third party interest cost, (ii) ensure that interest expense is matched with economic activity and (iii) use a worldwide approach.[13] These concerns are discussed hereafter from a policy perspective. These objectives can perhaps best be summarized as the desire to provide a balanced allocation of interest costs between the entities of a multinational group. The above raises some interesting questions in relation to EU Law. These questions are outside the scope of the present article.

The first objective that a group should be able to obtain tax relief for no more than the group's third party interest implies that it should not be possible to create additional deductions by entering into intragroup loans. This begs the question why these deductions should be denied or, in other words, why intragroup loans and third-party loans should be treated differently. According to the discussion draft: "a group-wide test directly addresses issues of base erosion where a group claims relief for interest expense in excess of its actual interest costs."[14] This implies that interest expenses on intragroup loans are not considered actual interest cost to the extent the additional deductions are created. Academics have submitted that intragroup loans are arguably a close or perfect substitute for equity.[15] The author notes that the logical consequence of this would be to treat intragroup loans as equity for tax purposes. Such a rule would, however, not take account of the fact that many international groups have centralized treasury operations in a group entity that operates as the group's bank. In this case third-party loans are obtained by a group finance company and on lent to various entities within the group. A rule that treats intragroup loans as equity for tax purposes should therefore be supplemented to allow for a deduction of interest on intragroup loans to extent it represents third party interest incurred by the group finance company. The group-wide rule that the discussion draft proposes, is simpler: it does not explicitly treat intragroup loans as equity but instead directly attributes part of the group's third party interest to the entities of the group.

The second objective that interest expense should be matched with economic activity implies that a state should only allow deductions of interest on loans used to finance business operations through which a taxpayer generates income that is taxable in that state.[16] Dividends received on shares in (foreign) participations are typically not subject to tax because of an exemption or an indirect credit. Therefore, interest on loans used to finance (foreign) subsidiaries should not be deductible for the taxpayer. Instead the interest on these loans should be attributed to the (foreign) subsidiaries in order to match deductible interest with taxable income.

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[13] Para 59.
[14] Para 60.
[15] See C.Burnett analysis in: "Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach, World Tax Journal February 2014, p. 57-62 and footnotes 56-60 for references to other academics who support this proposition. See also the comments from the Netherlands in Commission Decision of 8 July 2009 on the groepsrentebox scheme which the Netherlands is planning to implement (C 4/07 (ex N 465/06)), OJ 4.11.2009 L 288/26, par. 12 and 47.
[16] See also: Vleggeert (2014), p. 103.

The third objective is that an interest limitation rule should be based on a worldwide approach. This objective appears to be based on two propositions. The first proposition is in the words of Burnett that: “[a] multinational group’s choice of location for its third-party debt is influenced or even dominated by tax considerations.”[17] The second proposition is that debt is fungible and that therefore for tax purposes each entity of a multinational group should have the same level of debt as the group as a whole.[18] The author points out that a similar approach is used Part 1 of the Report on the “Attribution of Profits to Permanent Establishments”.[19] In attributing equity and debt to a permanent establishment, the capital allocation approach uses as its point of reference the financing structure of the enterprise as a whole. In the view of the present author, the worldwide approach entails applying this principle by analogy to companies that are members of a group.

3. Overview of the worldwide approach

3.1. Introductory remarks

3.1.1. Options for an interest limitation rule

In order to establish a general interest limitation rule to tackle beps through the use of interest cost, the discussion draft starts by examining rules that are currently applied by countries. The discussion draft identifies three groups of rules that should be given further consideration.[20] The first group concerns *fixed ratio rules* which limit the level of interest expense in an entity with reference to a fixed ratio such as debt to equity ratios or interest to EBITDA ratios. The discussion draft observes that these rules are relatively easy to apply but that they are inflexible as they apply the same ratio to entities in all sectors. In addition “there is evidence that the rates at which these ratios are currently set are too high to be an effective tool in addressing base erosion and profit shifting.”[21] The second group is *group-wide rules* which compare the level of debt in an entity by reference to the group's overall position (such as a debt to equity ratio). According to the discussion draft these rules are also easy to apply but “the amount of equity in an entity is not a good measure of its level of activity and equity levels can be easily subject to manipulation”.[22] The third group is *targeted rules*. The discussion draft points out that these rules can be effective in addressing specific beps risks. However, they typically result in a complex system.[23]

The countries engaged in the discussion draft agree that arm's-length tests, withholding taxes and rules which disallow a percentage of all interest paid by an entity should not form part of the consultation process.[24] An alternative that is not discussed is rules which treat debt as equity. These rules disallow the deduction of interest because interest is qualified as dividend. Naturally these rules would be effective in countering beps, but apparently they deviate too strongly from the current tax system of the countries involved. Another option that is not

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[17] Burnett (2014), p.65-66. Burnett claims that there is significant empirical evidence supporting this proposition. In that respect she refers to the studies mentioned in footnote 9 of her article. See also para’s 28-31 of the discussion draft.
[18] See Burnett (2014), p. 67-69. As the author indicated, the presumption of fungibility may need further exploration. Vleggeert (2014), p. 106.
[19] Par. 46 of the Commentary on art 7 OECD (2008).
[20] Para 19
[21] Para 16. See also para 27.
[22] Para 17.
[23] Para 18.
[24] Para 21 and 25.

considered, is rules that treat equity as debt and consequently allow a deduction for a return on equity. This is understandable as these rules would create additional possibilities for base erosion.

3.1.2. Preference for group-wide rules

On balance the countries involved in the discussion draft appear to have a clear preference for group-wide rules: "Group-wide tests in theory have the greatest potential to tackle base erosion and profit shifting using interest."[25] The discussion draft points out that the ability of fixed ratio rules to address beps is much smaller because of the problem of setting the benchmark ratio at the correct level.[26] And an approach based entirely on targeted rules is not suitable either because a comprehensive set of rules is expected to be too complex.[27]

A group-wide rule limits the amount of interest which can be deducted by each entity to a part of the group's third party interest expense. The discussion draft focuses on group-wide rules which work on two basic premises: "Firstly, that the best measure for total net interest deductions within a group is the group's actual net third party interest expense (ie. total interest paid to third parties less total interest income received from third parties). Secondly, that within a group interest expense should be matched with economic activity. Where net interest expense is matched with economic activity, groups will obtain tax relief for an amount equivalent to their actual third party interest cost."[28] Economic activity can be measured by using earnings or asset values. If earnings are used, dividend income will be excluded to ensure that a high level of (exempt) dividend income increases the amount of interest that an entity can deduct.[29] If asset values are used equity investments which give rise to (exempt) dividend income may be excluded.[30] The following example[31] illustrates how these rules could apply.

<u>Consolidated balance sheet</u>

Assets	1000	Equity	200
		Debt	800

<u>Balance sheet holdco</u>

Assets	400	Equity	200
Participation	150	Debt	350

<u>Balance sheet foreign subsidiary</u>

Assets	600	Equity	150
		Debt	450

It is assumed that the interest rate on debt is 10%. This means that the group's actual net third party interest expense is 80 (10% of 800). This amount is allocated to holdco and foreign foreign subsidiary based on economic activity. Secondly it is assumed that economic activity is measured using assets as an allocation factor. The allocation factor divides holdco's assets by the group's assets. For purposes of calculating the relevant assets of holdco the equity investment of 150 is excluded. Consequently the amount of deductible interest that is allocated to holdco is 400/1000 x 80 is 32. As holdco's actual interest expense amounts to 10% of 350 is 35, holdco's non-deductible interest is 3. The amount of deductible interest that

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[25] Para 60.
[26] Para 149.
[27] Para 179.
[28] Para 59.
[29] Para 108.
[30] Para 121.
[31] The example is derived from Vleggeert (2009), p. 197.

is allocated to foreign subsidiary is 600/1000 x 80 is 48. As foreign subsidiary's actual interest expense amounts to 10% of 450 is 45, the subsidiary should be allowed an extra deduction of 3 in order to ensure that the group's actual net third party interest expense of 80 is fully deductible. That is however not the solution that the discussion draft proposes. Instead the discussion draft suggests to allow holdco a carry forward of the amount of non-deductible interest of 3 to future periods.

In order to avoid that interest is not deductible, groups may seek to reorganise their intragroup financing. In fact the discussion draft intends to encourage groups to adopt funding structures that align interest expenses of individual entities with the amount that is deductible under a group-wide rule.[32] As the application of the rule requires that the amount of a group's third party interest or third-party debt and the amount of a group's earnings or assets is ascertained, the discussion draft recognises that the group's consolidated financial statements should be a good starting point for obtaining this information.[33]

Having provided an overview of the approaches suggested in the discussion draft, paragraph 3.2 – 3.7 will examine in more detail the main features of the group-wide rule that is put forward in the discussion draft. This article does not go into a number of more specific issues such as the scope of application of a group-wide rule, the definition of interest, a small entity exception, mismatches between tax and accounting rules and the treatment of groups in specific sectors.

3.2. Reference to interest expense or debt?

This paragraph discusses whether a group-wide rule should operate by reference to the level of interest expense or the level of debt. A rule that provides for the allocation of the entire interest expense within the group is, firstly, in line with the principle that groups should be able to deduct no less and no more than their actual third party interest cost. A rule based on debt that uses the group's average interest rate to determine an entity's deductible level of interest expense would, secondly, be similar to an interest expense based rule. However if the entity's (rather than the group's) average interest rate is used in this respect, an entity's deductible interest expense level could deviate from the amount allocated under an interest based rule. In this respect the discussion draft notes that such a rule may not deal with cases where an entity's tax base is eroded using high interest rates.[34] On the other hand, using an entity's average interest rate rather than the group average interest rate may be a better reflection of economic reality in case an entity operates in a high or low interest rate environment.[35] The discussion draft prefers interest expense-based rules.[36]

Under an interest expense-based group-wide rule, the amount of interest expense of the group must be determined. The obvious way to obtain this information is to use the group's commercial consolidated financial statements. The author submits that the implication of this is that international financial reporting standards (IFRS) or general accepted accounting principles (GAAP) should be decisive in determining what is interest.[37] If no specific

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[32] Para 10.
[33] Para 97.
[34] Para 44.
[35] Para 44.
[36] Para 45.
[37] See Vleggeert (2014), p. 106.

agreement is made in this respect, additional disparities may arise. Remarkably the discussion draft does not recognise this implication of using an interest expense-based rule.

3.3. Deemed interest rule or interest cap rule

3.3.1. Introductory remarks

Under a deemed interest rule each group entity is allowed a deduction of the amount of the group's third party interest that is allocated to it irrespective of the amount of interest that is actually incurred. This can be illustrated on the basis of the example that is given in paragraph 3.1. Under a deemed interest rule foreign subsidiary will be allowed an extra deduction of 3. In contrast under an interest cap rule the amount of the deduction cannot exceed the interest actually incurred. As a result foreign subsidiary will not be granted an extra deduction of 3.

As the discussion draft points out, the choice between a deemed interest rule and an interest cap rule is fundamental to the operation of the group-wide rule.[38] An important argument in favour of a deemed interest rule is that this rule ensures that the group's third party interest is deductible somewhere within the group. However, the countries involved in the discussion draft are concerned about opportunities for abuse if deemed interest rule were to be implemented: “For example, a deemed interest rule could operate as an incentive for groups to raise third party borrowings in countries which do not apply the rule and have the fewest protection against base erosion and profit shifting. A group could then benefit from a deduction for its actual interest cost which accrues in the entity which enters into the borrowing, and a second deemed deduction in group entities which are subject to an interest allocation rule.”[39] Clearly there will be an incentive to shift borrowings to countries that have not implemented a worldwide interest allocation rule. In the author's view this should, however, not be an issue for the countries that have implemented the deemed interest rule but for the countries that will not apply the group-wide rule. If a country allows a deduction of interest actually incurred and that amount exceeds the amount that would have been deductible under a worldwide interest allocation rule, the tax base of that country is eroded rather than the tax base of the countries that did implement a deemed interest rule. This may drive countries to spontaneously adopt a worldwide interest allocation rule.[40]

Apparently the fear for double deductions is the decisive factor in this matter, as the countries involved in the discussion draft agree that an interest limitation rule should be structured as an interest cap rule.[41] This does not mean that they do not see the risk that part of group’s third party interest expense might not be deductible. However, the discussion draft downplays this risk by suggesting that groups should be able to adapt their funding structure in order to align the interest actually incurred by group entities with the deduction allowed under the interest cap rule. This means that it is crucial that the outcome of the interest cap rule is predictable. It follows that it will be very difficult to use earnings as an allocation factor (see paragraph 3.6) or to allocate a group's currency exchange results on borrowings to entities of the group because earnings and currency exchange results are not predictable. Consequently, the choice for an interest cap rule has far-reaching consequences for the design of the group-wide rule.

3.3.2. Suggestion for a “transfer mechanism”

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[38] Para 70.
[39] Para 75.
[40] See Vleggeert (2014), p. 107.
[41] Para 77.

The author prefers the deemed interest rule because it avoids economic double taxation of interest, and because it offers more flexibility in the design of the group-wide rule. However, if the countries involved in the discussion draft persist in their choice for an interest cap rule, the author suggests supplementing the rule with a transfer mechanism to mitigate the risk of economic double taxation of interest. Such a mechanism could operate as follows.

A group entity that has interest expenses that are lower than the interest cap, is allowed to make a deductible payment to another group entity that has interest expenses that exceed the interest cap. The recipient has to include the amount transferred in its taxable profit and is at the same time allowed to increase the interest cap with this amount. This can be illustrated by using the same example as in paragraph 3.1. In this example foreign subsidiary's actual interest expense is 45 whereas its interest cap is 48. Under the transfer-mechanism foreign subsidiary is allowed to make a deductible payment of 3 to holdco. The payment is treated as interest for purposes of the interest cap rule. As a result foreign subsidiary's interest expense will equal the amount of the interest cap (48). In the example holdco's actual interest expense is 35 whereas holdco's interest cap is 32. Under the transfer-mechanism the amount that holdco receives from foreign subsidiary is added to holdco's interest cap. Therefore holdco's interest cap will be 35 and as a result holdco is allowed to deduct its entire interest expense.

In order to avoid abuse, it is important that the transfer mechanism is only applicable if *both* the country of the payor and the country of the payee apply a group-wide interest rule. In addition to this the amount paid under the transfer mechanism by a group entity should not exceed the difference between its interest cap and actual interest expense. Moreover, the amount paid to another group entity cannot exceed the difference between the actual interest expense and the interest cap of that entity. As the size of the amount to be transferred can only be determined after the end of the book year to which the deductible payment relates, the deduction should be subject to the condition that the amount will be paid within for example one year after the end of the book year concerned.

The transfer-mechanism should ensure that a group's third-party interest is always deductible somewhere within groups that only have domestic operations. In addition the transfer-mechanism should apply to cross-border situations because otherwise the EU treaty freedoms would be infringed. This means that the risk of economic double taxation of interest will also be mitigated in cross-border situations. In contrast to the deemed interest rule, the application of the transfer mechanism in cross-border situations cannot operate as an incentive for groups to raise third party borrowings in countries which do not apply the rule.

3.4. <u>Focus on gross position or net position (also taking into account interest income or debt assets)?</u>

The next question is whether an interest limitation rule should be applied on a gross or net basis. A gross interest limitation rule will apply to interest incurred whereas a net interest limitation rule will apply to the difference between interest incurred an interest income earned on loans and deposits (net interest expense). Firstly, this means that under a net interest rule the amount that is allocated is a *group*'s net third party interest expense (the difference between third party interest incurred and third party interest received). Secondly, it entails that the non-deductible amount is the difference between a *group entity's* net interest expense (interest incurred less interest received) and the interest cap. The discussion draft proposes that an interest limitation rule should apply on a net basis because a gross interest rule could lead to double taxation of interest paid on intragroup loans.[42] This can be illustrated by using the same example as in paragraph 3.1. except that holdco now provides a loan of 30 to foreign subsidiary. Consequently the balance sheets are as follows:

Consolidated balance sheet

Assets	1000	Equity	200
		Debt	800

Balance sheet holdco

Assets	400	Equity	200
Participation	120	Debt	350
Loan to sub.	30		

Balance sheet foreign subsidiary

Assets	600	Equity	120
		Debt	480

The third party interest allocated to holdco and foreign subsidiary is still 32 and 48 respectively (note that assets are used as an allocation factor and that for purposes of calculating holdco's relevant assets not only the participation but also the intragroup loan is excluded as these assets do not appear on the consolidated balance sheet). However, holdco's non-deductible interest is now calculated on a net basis. Holdco's net interest expense is 35 – 3 (10% on 30) is 32. As this amount equals the interest cap the interest incurred by holdco is entirely deductible. The interest incurred by foreign subsidiary (48) is also fully deductible as it equals the amount of foreign subsidiary's interest cap.

The author submits that the same result could be achieved under an interest limitation rule that is applied on a *gross* basis provided that interest received on intragroup loans is exempted. Under a gross interest rule holdco's non-deductible interest would amount to 3 but interest on the loan to foreign subsidiary (3) would be exempt. In fact this alternative is better suited to avoid double taxation of interest on intragroup loans than the net interest rule that is proposed in the discussion draft. This can be illustrated by using the same example except that holdco now has provided a loan of 100 to foreign subsidiary. Consequently the balance sheets are as follows:

Consolidated balance sheet

Assets	1000	Equity	200
		Debt	800

Balance sheet holdco

Assets	400	Equity	200
Participation	50	Debt	350
Loan to sub.	100		

Balance sheet foreign subsidiary

Assets	600	Equity	50
		Debt	550

Again, the third party interest allocated to holdco and foreign subsidiary is 32 and 48 respectively. Holdco's net interest expense is 35 – 10 (10% on 100) is 25. As this amount is lower than holdco's interest cap, the interest incurred by holdco is fully deductible. However as the interest on the loan to foreign subsidiary is taxable, holdco's net deduction is only 25. Foreign subsidiary's net interest expense is 55. As this amount exceeds foreign subsidiary's interest cap the difference of 7 is not deductible. This is the amount that is subject to economic double taxation. However, if alternatively the interest limitation rule is applied on a

[42] Para 47.

gross basis and interest received on intragroup loans is exempted, holdco's deductible interest expense will amount to 32 (3 being non-deductible) and interest on the loan to foreign subsidiary will be exempt. As a result the group's third party interest is effectively entirely deductible.

In conclusion, an interest limitation rule that operates on a gross basis and exempts interest received on intragroup loans is better suited to avoid economic double taxation than a net interest limitation rule. Also the discussion draft points out that a gross interest rule is likely to be more difficult for groups to avoid through planning than a net interest rule: "a rule which applies to net interest expense could be ineffective if groups can avoid the rule by converting other forms of taxable income into interest income, reducing the level of net interest to which the rule can apply. In addition, applying a rule to net interest expense would mean it has no impact on entities, such as banks, which are recipients of net interest income".[43] Therefore, the author submits that an interest limitation rule should operate on a gross rather than a net basis.

However, there are two issues that need to be addressed if a gross interest rule is applied and interest received on intragroup loans is exempted. First, as pointed out in paragraph 3.1. under an interest cap rule countries might allow a group entity to carry forward the amount of non-deductible interest to future periods in order to avoid economic double taxation. In the example this would mean that foreign subsidiary is allowed to carry forward the non-deductible interest of 7. However, if the interest on the loan to foreign subsidiary is exempt for holdco there is no need to allow foreign subsidiary a carry forward because the group's third party interest is effectively entirely deductible. Therefore, under an interest cap rule, a carry forward should only be granted to the extent the amount of non-deductible interest exceeds the group entity's interest on intragroup debt.

Secondly, countries might be concerned about opportunities for abuse if a rule exempting interest received on intragroup loans were to be implemented. This rule could be an incentive to provide intragroup loans to group entity's that are resident in countries that have not implemented a group-wide interest rule and consequently would allow a deduction for intragroup interest. Therefore an exemption for interest received on intragroup loans should only apply provided that the country of the debtor has implemented a group-wide rule that allows a deduction of interest on the basis of allocation of the group's third party interest.

3.5. <u>Group-wide interest allocation rule or group ratio rule?</u>

A subsequent issue is whether a group-wide interest allocation rule or a group ratio rule should apply. A group-wide interest allocation rule operates by allocating a group's net third-party interest expense to group entities. A group ratio rule compares a financial ratio such as net interest to earnings or net interest to assets values of a group entity with that of the worldwide group. To the extent an entity's ratio is above that of the group, its net interest expense is disallowed. The discussion draft observes that these two approaches are in principle very similar.[44] On the other hand the discussion draft submits that countries might have greater flexibility in the design of a group ratio rule: "for the purposes of this consultation document, it is anticipated that an interest allocation rule would be applied consistently, with all countries applying the rule reaching agreement on the main elements (such as the definition of a group, the calculation of the group's net third party interest

[43] Para 48.
[44] Para 68.

expense, and the allocation of interest expense between group entities). On the other hand, a group ratio rule would be applied more flexibly, with greater scope for a country to use its own approaches for determining each of these elements (…).”[45] However, flexibility comes at the expense of consistency. Differences between group ratio rules in different countries could give rise to economic double taxation of interest or create opportunities for beps.[46] The author therefore prefers interest allocation rules that are applied consistently by as many countries as possible.

3.6. Measuring economic activity using earnings or asset values?

A group-wide rule allocates a group's net third-party interest to the group entities in accordance with a measure of economic activity. The discussion draft considers extensively whether economic activity should be measured using earnings or asset values. In order to avoid a significant compliance burden for groups the discussion draft proposes to use accounting figures to measure earnings or asset values.[47] The discussion draft submits that the level of earnings is usually the clearest indicator of value creation across the group.[48] In addition the level of earnings is a direct measure of an entity's ability to meet its obligations to pay interest.[49] Further a group-wide rule measuring economic activity using earnings is better suited to counter beps than rule using asset values because it directly links the deduction of interest to the level of earnings.[50] On the other hand the value of an entity's assets is a key factor in determining the amount of debt it is able to borrow.[51] Another important feature of asset values is that they are more predictable than earnings: “This means that using asset values as a basis for measuring economic activity within a group should give rise to a relatively steady and predictable limit on the level of relief that can be claimed. This would improve certainty for groups and could also reduce compliance costs. In addition, an approach based on asset values would mean that entities with losses would still be able to deduct an amount of net interest expense, which would not be possible under an earnings-based approach.”[52]

The author submits that if the countries involved in the discussion draft persist in their choice for an interest cap rule, the predictability of asset values should be the decisive factor. As explained in paragraph 3.3 an interest cap rule implies that groups must be able to adapt their funding structure to the outcome of the rule. It follows that it is crucial that the outcome of an interest cap rule is predictable. The author is of the view that this means that earnings are therefore less suitable as an allocation factor than asset values as earnings tend to be less predictable. Consequently under an interest cap rule economic activity should be measured using asset values.

The discussion draft correctly submits that not all categories of assets should be included in the calculation of an entity's asset values. It also further notes that, in the view of the present author, assets that are not included in a multinational's consolidated balance sheet should be excluded from an entity's asset values. Consequently shareholdings in other group companies

[45] Para 68.
[46] Para 86.
[47] Para 103.
[48] Para 105.
[49] Para 106.
[50] Para 107 and 120.
[51] Para 120.
[52] Para 123.

and loans granted to other group companies should be ignored.[53] The discussion draft suggests also excluding equity investments that are not group companies provided that they generate tax exempt and tax deferred income and financial assets that are not loans to other group companies if they give rise to interest income.[54] However, this suggestion conflicts with the objective to make sure that a group‘s third-party interest is deductible somewhere as these assets are included in the group's consolidated balance sheet.

The main disadvantage of using asset values to measure economic activity, is that internally created intangibles are typically not on a group's commercial balance sheet. The discussion draft recognises that the impact of this is that for a number of large groups the group’s most valuable assets will not be taken into account.[55] The author therefore suggest to give groups the option to measure economic activity using earnings rather than asset values on the condition that the earnings method is applied consistently throughout the group.

3.7. The treatment of non-deductible interest expense and double taxation

Chapter XII of the discussion draft deals with the treatment of non-deductible interest expense and double taxation. It appears that the objective to counter beps takes precedence over the principle that a group’s third-party interest should always be deductible somewhere (or in other words: that economic double taxation on interest is avoided): “While the critical aim of this work is to prevent base erosion and profit shifting, the countries involved in this work are also concerned by the risk of economic double taxation and agree that this should be avoided where possible. At the same time it is recognised that double taxation may arise as a result of structures that were implemented to achieve base erosion and profit shifting outcomes.”[56] This section implies that according to the countries that are involved in the discussion draft economic double taxation on interest might be acceptable in cases where multinationals deliberately intend to erode the tax base through interest expenses. The author submits that this line of reasoning is debatable as it may not be possible to determine whether beps was intended. Moreover, the group-wide rule does not attempt to ascertain whether a group planned to erode the tax base (i.e. intent).

The discussion draft proposes to avoid economic double taxation on interest by providing for a carryforward of disallowed interest expense and possibly for a carryforward of unused capacity to deduct interest.[57] In order to avoid that a carryforward provision is abused, the discussion draft suggests that it should be restricted in terms of the number of years of a carryforward and possibly also as to the amount of the carryforward.[58]

4. Do the worldwide interest allocation rules meet the main policy concerns?

This paragraph discusses whether the group-wide rule meets the first three policy concerns that were identified in paragraph 2. This paragraph will not deal with EU law issues (these issues will be considered as the work on action 4 progresses) and the fairness of a group-wide rule (this issue is examined in paragraph 2.6).

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[53] Vleggeert (2014), p. 104.
[54] Para 121.
[55] Para 125 and 126.
[56] Para 183.
[57] Para 198.
[58] Para 198.

The main objective of the discussion draft is to address beps using interest on third-party and related party loans. In paragraph 2.2. four techniques to achieve beps are recognized. First, the group-wide rule should counter the use of intragroup loans to generate deductible interest cost in high tax jurisdictions and taxable interest income in low tax jurisdictions. The group-wide rule achieves this aim because a group's deductible interest cannot exceed the group's third-party interest. Therefore it is no longer possible to create additional deductions by entering into intragroup loans. Secondly, the group-wide rule should deal with the use of interest deductions to fund income which is exempt or deferred for tax purposes. This is accomplished because equity investments which give rise to exempt or deferred dividend income are excluded if asset values are used as an allocation factor (dividends are excluded if earnings are used as an allocation factor). Thirdly, the group-wide rule should avoid the allocation of a disproportionate share of a group's total third-party interest cost to high taxed operating companies. The rule does this because it attributes a group's third-party interest expense to the group entities based on objective allocation factor. Finally a group-wide rule should tackle hybrid mismatches resulting in double non-taxation of interest. The rule does address hybrid instruments which give rise to deductible interest expense but no corresponding taxable income because these instruments are typically structured as intragroup loans. However, other hybrid mismatches such as double deduction schemes that use a hybrid entity are not addressed. These mismatches should be dealt with in the work that is done on Action 2 (hybrid mismatches). In conclusion, it is submitted that the group-wide rule meets the main objective to address beps using interest expense.

In the second place a group-wide rule should not give rise to economic double taxation of interest. This means that a group's third-party interest should be deductible somewhere within the group. The author favors a deemed interest rule that allows for a deduction of the amount of a group third-party interest that is attributed to each group entity irrespective of the interest that is actually incurred by an entity. However, the discussion draft proposes an interest cap rule that provides that the interest incurred by an entity cannot exceed the amount of a group's third party interest that is allocated to it. An excess will not be deductible but may be carried to future years. The discussion draft proposes that the carryforward should be restricted in terms of the number of years. It follows that a group third-party interest may - in part - not be deductible if a group entity is not able to use the carryforward in time. In order to mitigate the risk of economic double taxation of interest the author therefore suggests supplementing the interest cap rule with a mechanism that allows for the transfer of unused capacity to deduct interest of an entity to another entity that has interest expense that exceeds the interest cap.

The discussion draft proposes that a group-wide rule should apply on a net basis because a gross interest rule could lead to double taxation of interest paid on intragroup loans. However, the author submits that an interest limitation rule that operates on a gross basis and exempts interest received on intragroup loans is better suited to avoid economic double taxation than a net rule. In order to avoid abuse the exemption should only apply provided that the country of the debtor has a group-wide rule. Assuming the countries involved in the discussion draft persist in their choice for an interest cap rule, the author submits that the rule should operate as a gross rule and be supplemented with a transfer-mechanism.

The third policy concern involves minimizing distortions to competition and investment and providing certainty of outcome. These policy concerns imply in the first place that a group-wide rule should be applied consistently by as many countries as possible. Secondly the implications of the rule should be predictable in order to enable groups to adapt their funding structure to the outcome of the interest cap rule. The author is of the view that this means that earnings are less suitable as an allocation factor than asset values because earnings tend to be less predictable. Therefore, asset values should be used to attribute a group's third-party interest expense. Furthermore it could be considered give groups the option to measure economic activity using earnings provided that earnings will be used as an allocation factor consistently throughout the group.

5. Conclusions

The discussion draft proposes a group-wide rule that limits the amount of interest which can be deducted by each entity to a part of the group's third-party interest expense. The author welcomes this approach, which appears to be suited to counter beps using interest expenses. However, the author suggests that the countries involved in the discussion draft adapt the group-wide rule to mitigate the risk of economic double taxation of third-party interest. Therefore, the author favors a deemed interest rule that allows for a deduction of the amount of a group's third-party interest that is attributed to each group entity irrespective of the interest that is actually incurred by an entity.